BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

August 16, 2011

The Honorable Sherrod Brown
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to the questions you posed in your June 1, 2011, letter.

I hope this information is helpful to you.

Sincerely,

Enclosure

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Brown, as posed in the June 1, 2011, letter:

1. Why did you purposefully design an opaque test?

The Federal Reserve supports, and has advocated for, greater transparency in supervision. A dynamic regulatory regime is most likely to be realized if it receives non-governmental perspectives on its objectives, methods, and practices. In addition to disclosing more data to investors and counterparties, exposing supervisory practices and policies to external assessment in a structured way can improve supervision.[1]

As part of the Supervisory Capital Assessment Program (SCAP) in 2009, we took the unusual step of releasing publicly the methodology and findings of our analysis, including the capital needs and loss estimates for the 19 institutions. The decision to make this information public was made in the context of a systemic crisis, in which markets were hungry for information, wide variations existed among private sector estimates of future potential losses, and a government backstop was in place to support firms unable to access private markets to meet their capital needs. Even so, this decision was much debated within the Federal Reserve, in part because of concerns that the information could be misinterpreted, that weaker banks might be significantly harmed by the disclosures, potentially further de-stabilizing markets. Nevertheless, the SCAP in retrospect accomplished the supervisory objective of ensuring these 19 firms had sufficient capital to withstand an adverse scenario, but also served to reduce market uncertainty by providing a credible estimate of potential future losses.

The Comprehensive Capital Analysis and Review (CCAR) that concluded in April 2011 was conducted under different circumstances, and its objectives were much broader than the SCAP. While the SCAP was an evaluation of potential stressed capital levels, the CCAR was an evaluation of the firms' internal capital planning processes, including their proposed capital actions. CCAR assessed the processes used by the firms to manage and assess their risks and capital adequacy on an ongoing and forward-looking basis, using stress test results as inputs. The CCAR did not involve supervisors conducting full-fledged supervisory stress tests; rather we developed sensitivity analyses of the firms' stress test results and, in some key areas, developed independent assessments to inform our overall evaluation of the firms' capital plans. We did, however, publish a white paper on March 18, 2011, that detailed the objectives, process, and assumptions used in the CCAR process to allow external review and evaluation of the CCAR process.

We recognize that as we move forward, greater transparency around stress tests deserves serious consideration for at least two reasons. First, it would promote increased market discipline, as releasing such information could assist investors in the difficult task of valuing loan portfolios that at present are not very transparent. Second, releasing details about assumptions, methods, and conclusions would expose our supervisory approach to greater outside scrutiny and discussion. Whether the result is a critique or validation of our approach, the reaction of informed investors and analysts to our assumptions and methods would be

[1] See Governor Daniel K. Tarullo (2010), "Involving Markets and the Public in Financial Regulation," remarks delivered at the Council of Institutional Investors Meeting, Washington, DC, April.

beneficial. Finally, I would note that public disclosure of stress tests mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act is required; the form of such disclosure is currently under discussion, and a proposed approach will be published for public comment.

2. Do you believe that efficient markets require transparency?

Please refer to the response to question 1.

3. What steps has the Federal Reserve taken to address existing and potential market distortions created by undercapitalized banks?

The recent crisis demonstrated that most large banking organizations (and, indeed, most large financial institutions generally) underestimated the amount and quality of capital required for them to withstand stressful circumstances and continue as viable entities. Since the onset of the crisis, the Federal Reserve has led a series of initiatives to strengthen the capital positions of large, complex banking organizations. In 2009, the SCAP analysis led by the Federal Reserve resulted in an incremental increase of $75 billion in Tier 1 common capital. In addition, large firms that had accessed TARP capital were required to issue new common equity in connection with their redemption and were required to restrict capital distributions. As a result, the 19 SCAP firms have increased their common equity by over $300 billion since late 2008. Over this same period, the average Tier 1 common capital ratio for the 19 SCAP firms increased from 8.7 percent to 10.1 percent. To ensure these firms continued to operate at an appropriate capital level, the Federal Reserve conducted the CCAR review in 2011. The CCAR was designed to ensure that large, complex firms continue to build capital and that dividend increases and other capital distributions are prudent. On June 10, 2011, the Federal Reserve issued a proposed rule that would formalize this process, requiring annual capital plans and a mechanism for the Federal Reserve to object to such plans and proposed capital distributions to shareholders.

The Federal Reserve also took a leading role in the development of the Basel III regime to ensure stronger prudential standards for capital adequacy for internationally active banks, which will support a more level playing field across countries. We are now hard at work developing proposals to implement Basel III in the United States. An important capital policy initiative that has yet to be completed pertains to additional capital requirements for systemically important financial institutions (SIFIs), as required under Section 165. On June 25, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, agreed on capital requirements for global systemically important banks. Under the agreement, which is expected to be issued for public comment later this month, such firms will be subject to a progressive Tier 1 common equity capital surcharge ranging from 1 percent to 2.5 percent based on the firm's systemic importance. An additional 1 percent surcharge would be applied to the most systemic banking firms if they materially increase their global systemic footprint. The higher loss absorbency requirements will be phased in between January 1, 2016, and January 1, 2019. Domestically, the Federal Reserve will continue with the process of developing enhanced prudential standards for SIFIs that increase U.S. financial stability and reduce moral hazard.

4. Are U.S. banks compliant with Basel III?

The final Basel III rules agreed to by the Basel Committee in 2010 include a lengthy transition period from 2013 to 2019 to mitigate any potential short-term adverse macroeconomic effects. Although Basel III applies its terms to internationally active banks, the Board and the other federal banking agencies have not yet determined the scope of its application to U.S. banks or otherwise adopted U.S. implementing regulations. Because the final U.S. Basel III rules are not in place, we cannot say with certainty when subject firms will comply. However, as part of CCAR, we assessed each of the 19 firms' plans and timelines for coming into compliance with Basel III based on the generalized framework published by the Basel Committee. Based on this review, we believe that these firms have appropriate plans in place to comply with Basel III requirements as they come into force in the United States.

5. Do you believe that enhanced capital requirements will make U.S. banks less competitive?

We do not believe that the enhanced capital requirements under Basel III, including the SIFI capital surcharge, will make U.S. banks less competitive internationally. Basel III is expected, among other things, to reduce differences in the definition of capital, improve disclosure, and raise capital requirements for internationally active banking organizations throughout the world, not just for U.S. banking organizations. We strongly support efforts to increase the level and quality of regulatory capital for banking organizations, but fully understand that banking organizations need sufficient time to build their capital bases to meet the new capital requirements. Accordingly, the U.S. and foreign implementation of Basel III will incorporate lengthy phase-in arrangements to help minimize any potential adverse effects the transition to Basel III may have on credit availability and economic growth.

The financial stability benefits of the Basel III reforms will be realized only if they are implemented rigorously and consistently across jurisdictions. In this regard, incorporating internationally acceptable standards into national legislation or regulations is only the first step in effective implementation. A second, critical step is ensuring that these standards are, in practice, rigorously enforced by national supervisors and observed by firms across all the Basel Committee countries. An international process for monitoring implementation on a bank-by-bank basis has become increasingly necessary as capital standards have relied to a greater extent on internal market-risk or credit-risk models, the parameters and operation of which are not transparent. The Federal Reserve is working with its counterparts on the Basel Committee to design implementation monitoring mechanisms and reduce inconsistencies in regulatory capital calculations.

6. How can you determine that banks are holding adequate capital when the capital requirements that will apply to Systemically Important Financial Institutions (SIFIs) are unknown?

As noted above, international supervisors only recently agreed to a proposed SIFI surcharge for globally active firms, which would be phased in over a three-year period beginning January 1, 2016, and the Federal Reserve is in the process of developing enhanced capital standards for SIFIs as required under the Dodd-Frank Act. In the absence of specific requirements, the CCAR was designed as a forward-looking, detailed evaluation of capital planning and stress scenario analysis. We assessed each firm's ability, after taking into account proposed capital actions, to maintain sufficient capital levels to continue lending in stressed economic environments, including under an adverse scenario specified by the Federal Reserve. As noted previously, we also assessed each of the firms' plans and timelines for coming into compliance with Basel III based on the generalized framework published by the Basel Committee, which allowed us to better understand banks' preparedness for complying with higher capital standards as they come into effect.